

Accrual Accounting for Military Retirement: Alternative Approaches

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CONGRESSIONAL BUDGET OFFICE

**ACCRUAL ACCOUNTING FOR MILITARY RETIREMENT:
ALTERNATIVE APPROACHES**

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PREFACE

The House Armed Services Committee, along with the Administration, has proposed major changes in the way the federal budget accounts for the costs of military retirement. Under the proposals, the budget would reflect costs of retirement benefits being earned by today's military personnel, whereas at present it reflects only the costs of those already retired. This study, prepared at the request of the Defense Subcommittee of the House Committee on Appropriations, describes the proposals, estimates their impact on the federal budget, and cites their important advantages--as well as associated concerns and ways to minimize them.

Although the study makes no recommendations as to the merits of these specific proposals, it is the judgment of the Congressional Budget Office (CBO) that the accounting concepts underlying the proposals are sound and should be implemented. To do so would greatly improve the usefulness of the defense budget by making the full costs of military manpower more visible. It would also assist future debates over changes in military retirement benefits by clarifying long-run cost effects; this should help avoid undue emphasis on near-term economies.

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SUMMARY

The true costs of military personnel include not only their costs while in service but also their pay after they retire. At a time when the Department of Defense and the Congress are forced by budgetary considerations to make difficult choices in the areas of personnel costs and weapons procurement, it is essential to be aware of the true cost of military personnel in relationship to the cost of other defense resources. Under the federal government's present accounting procedures, the budget includes the cost of benefit payments to service personnel who are already retired and to their survivors. It fails to show the liability taxpayers are incurring for the future retirement costs of military personnel now on active or reserve duty.

The Administration has proposed legislation to remedy this by placing the system on an "accrual" cost basis that would include liabilities as they are incurred. The House Armed Services Committee, in the Defense Authorization Bill for Fiscal Year 1984, has reported legislation similar to the Administration's proposal; if enacted, it would take effect with the fiscal year 1985 budget.

What Accrual Accounting Is

Accrual accounting is a method of recording costs and setting aside funds in current budgets to pay the retirement annuities that eventually will be received by military personnel who are in current service. It would improve military personnel management by making the full cost of manpower more visible, as well as clarifying the full cost of any change in retirement benefits. It would not affect the amount of retirement benefits paid to an employee when he or she retires, nor would it affect the annual outlays paid by the federal government.

Most proposals, including those of the House Armed Services Committee and the Administration, would make the following major changes in the way the budget accounts for retired pay:

- o A charge for retirement costs accrued by today's military personnel would be added to the defense function. This "accrual" charge would be the amount actuaries estimate would be necessary to fund the retirement benefits earned each year by today's military personnel. It would reflect expected growth in wages, prices, and interest rates.

- o The defense retired pay appropriation would be transferred out of the defense function of the budget and absorbed into the trust fund discussed below. (The retired pay appropriation pays benefits to former military personnel currently on the retired rolls and to their survivors.)
- o A military trust fund would be created and shown in the income security function of the budget. The fund would receive the annual accrual charge, a payment for retirement liabilities built up before the fund's existence, and interest on the trust fund balance. This trust fund would also pay all retirement benefits (both current and future) from the funds it receives.
- o A board of actuaries would be created to oversee the fund and to make needed technical calculations.

Advantages and Potential Concerns

Accrual accounting would have many important advantages. It would improve manpower management by ensuring that future retired pay costs are considered during today's force structure decisions. For example, under the present budgeting system, the Administration's proposal to add 180,000 persons to the active-duty military over the next five years would have no effect on nondisability retirement costs in the current defense budget. Under accrual accounting, retirement costs would increase by \$1.2 billion, thus making clear the true costs of adding personnel at the time of the decision. Similarly, accrual accounting would ensure that the Administration and the Congress faced the full costs of their pay raise decisions, which have important though long-delayed effects on retirement costs.

Accrual accounting would also aid the Congress in evaluating the long-range budgetary effects of prospective modifications in the retirement system. This should avoid undue emphasis on immediate benefit cuts that offer short-term savings.

A potential concern associated with the accrual approach is its sensitivity to technical assumptions about changes in future prices, wages, and interest rates. Different assumptions about these variables could result in different estimates of current costs, thus increasing or decreasing the defense budget. The establishment of an independent board of actuaries to determine the appropriate economic and actuarial assumptions should, however, prevent manipulation of the defense budget for political purposes through arbitrary changes in the underlying assumptions.

A switch to accrual accounting might also confuse the debate over real defense growth, since the change could affect the size of the defense budget. This concern could be overcome by restating data on past defense budgets in accrual terms.

Because it offers many advantages and no problems that cannot be overcome, accrual accounting has been widely recommended. This Administration has recommended the change, as did its predecessor. Accrual accounting has also been recommended by the General Accounting Office.

Effects on Budget Authority and Outlays

Accrual accounting would mean changes in the relative magnitudes of outlays and budget authority in various parts of the federal budget. The House Armed Services and Administration approaches would generally have similar effects and so are discussed together.

Both approaches would result in a modest decline (in any given year) in the budget authority and outlays of the defense function. The two alternatives would add the accrual charge to both budget authority and outlays in the defense function but move the financing of current retirement benefits out of the defense function into the income security function. Relative to the current accounting method, this would decrease the defense function by \$0.6 billion in budget authority and outlays in fiscal year 1985. In addition, the Administration approach would also make a payment for the so-called unfunded liability--the liability built up before implementation of the new system--within the defense function, but the payment would also be offset within that function and so would not affect the total defense budget.

Both approaches would also make changes in other budget functions, including the income security function (where the trust fund would be located and from which, under the House Armed Services Committee approach, appropriations to pay off the unfunded liability would be made) and the offsetting receipts functions (where accounting transactions would occur to avoid double counting).

Outlays in the total federal budget would remain unchanged, since accrual accounting does not affect the size of retirement benefits. On the other hand, overall budget authority would increase once the budget began recognizing future retirement liabilities and the unfunded liability. CBO estimates that budget authority could increase by up to \$16.1 billion in fiscal year 1985, depending on the technical assumptions chosen, particularly the period used to amortize the unfunded liability.

CHAPTER I. THE CURRENT ACCOUNTING PROCEDURES FOR MILITARY RETIREMENT AND PROPOSED CHANGES

The present budgeting method for military retirement fails to reflect the liability taxpayers are incurring for the future retirement costs of today's military personnel. Instead, current appropriations for military retirement show only the cost of benefit payments to those already retired or their survivors. ^{1/} At a time when the Department of Defense and the Congress are forced by budgetary considerations to make difficult choices in the areas of force manning and weapons procurement, knowledge of the true cost of military personnel in relationship to the cost of other defense resources is essential to ensure maximum defense capability and budget efficiency.

In order to measure today's defense costs accurately, the defense budget should reflect the future retirement liabilities being built up each year by those contributing to today's defense effort. The Administration (like some of its predecessors) has proposed legislation to change the accounting method for military retirement to an "accrual" cost basis. Accrual accounting would explicitly recognize in the current budget the future retirement liabilities being built up each year by today's military personnel. A separate legislative proposal contained in the version of the Defense Authorization Bill reported by the House Armed Services Committee for fiscal year 1984 provides for similar accounting modifications. ^{2/}

A switch to accrual accounting would make the defense budget a better measure of the cost of today's defense activity. It would also improve military personnel management by making the full cost of manpower more visible, as well as showing the cost effects of changes in retirement benefits. This chapter analyzes the pros and cons of accrual accounting in general terms. Chapter II shows the accounting changes that would be necessary to implement the proposals of the House Armed Services Committee and the Administration.

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1. For a brief description of the current military retirement system, see Appendix A.
 2. At the time this report went to press, the House was debating but had not taken final action on this bill.

What Accrual Accounting Is

Accrual accounting records costs as they are incurred rather than when they are paid. It would mean setting aside in today's military budgets sufficient funds to pay the retirement benefits that current military personnel will eventually receive. ^{3/} Most proposals would make the following changes in the federal budget's method of accounting for military retirement (see Table 1):

- o An "accrual charge" for the future retirement costs of today's military personnel would be added to budget authority and outlays in the defense function; the charge would equal the amount actuaries estimate would fully fund the retirement benefits earned each year by today's military force. ^{4/}
- o Payments for those already retired--which are determined mostly by past decisions--would be transferred out of the defense function into the income security function where costs for Civil Service and Social Security retirees are currently recorded.
- o Money would be provided to fund over a period of time the liabilities for retirement benefits built up before the implementation of accrual accounting.

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3. Accrual methods are used extensively in business accounting to record costs, revenues, and profits when they actually occur, even though the funds involved may be paid out or received at other dates.
 4. More specifically, the annual charge is the amount that must be set aside each year so that the discounted present value of the charges over the entire career of a group of military employees is equal to the discounted present value of retirement benefits that must be paid to those who remain in the service long enough to retire. Thus the calculation considers all employees, not just those who retire, and assumes varying lengths of service. The charge also depends on future inflation, wage growth, and interest rates. It is usually expressed as a level percent of the annual basic payroll. The accrual charge could remain in the defense function (050) or be transferred to another budget function such as income security (600). The underlying principle of accrual accounting would be better served by the transfer. If transferred to the income security function, it would not only be recorded immediately in budget authority of the defense function but also in outlays as well.

TABLE 1. HOW ACCRUAL ACCOUNTING WOULD DIFFER FROM PRESENT BUDGET ACCOUNTING

Budget Function	Budget Authority	Outlays	Explanation of Change
Current Accounting			
Defense (050)	Payments to those already retired	Payments to those already retired	

Proposed Accrual Accounting			
Defense (050)	Accrual Charge	Accrual Charge	Outlay entry, which is offset below, ensures that defense function reflects future costs
Defense (050) or General Government (800) <u>a/</u>	Payments for unfunded liability	Payments for unfunded liability	Entry pays off past liabilities
Income Security (600)	Accrual Charge plus unfunded liability		Transfers from 050 and other functions
		Payments to those already retired	
Undistributed Offsetting Receipts (950)	-Accrual Charge	-Accrual Charge	Offsets outlay in 050 and eliminates double counting of budget authority

- a. Appropriate offsetting entries would be made in these same functions to offset outlays and eliminate double counting of budget authority.

- o A trust fund would be created to receive the accrual charge, the payment on the unfunded liability, and other payments. These funds would be used to pay all retirees (both current and future).
- o A board of actuaries would be created to oversee the trust fund and make needed technical calculations.

These changes would only modify accounting procedures. The adoption of accrual accounting would not affect actual pay or benefit levels for military personnel or current retirees. Nor would accrual accounting affect the retirement costs to the federal government.

The key accounting change is the placement of the accrual charge in the defense function, which ensures the visibility of retirement costs in the defense budget. The proposals of the House Armed Services Committee and the Administration would also establish an interest-bearing trust fund, though this is not a key change. The fund would receive the annual accrual charge along with periodic payments to liquidate the retirement liabilities built up prior to the adoption of accrual accounting. While neither a trust fund nor paying off the "unfunded liability" are necessary features of an accrual system, there are good reasons why the Congress might opt for both. A trust fund would bring the military retirement system closer to the system for Civil Service retirement, which has a trust fund.^{5/} Moreover, by having a trust fund and paying off the unfunded liability the military system would follow the practice of many private-sector pension plans which are required by law to have actuarially sound accrual systems. The Congress might wish to do this to emphasize the government's role as a model employer. (For more discussion of the trust fund and unfunded liability, see Appendix B.)

Advantages of Accrual Accounting

Accrual accounting would improve manpower management by incorporating future retired pay costs into today's budgetary process and force structure decisions. For example, under the present budgeting system, the

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5. In addition to a trust fund, the Civil Service retirement system is financed through accrual charges in agency budgets. However, unlike the proposed accounting changes in military retirement, the accrual charge in civil service retirement does not fully reflect future wage and price growth, thus understating the appropriate amount of the charge.

Administration's proposal to add 180,000 persons to the military over the next five years would have no effect on nondisability retirement costs as reflected in the defense budget until some of them began retiring--that is, in about 20 years. These costs are likely to be ignored during the planning stage. Under accrual accounting, the addition of 180,000 persons to the military would increase retirement costs in the current defense budget by about \$1.2 billion and thus make clear the true cost of adding personnel at the time the decision to increase the size of the military was made.

Much the same is true of pay decisions. Annual decisions about the size of the military pay raise eventually affect retirement costs, especially if--as has sometimes been the case in recent years--larger raises are provided to senior personnel. Under present accounting methods, the full effects of pay raises on retirement costs do not show up for many years. Accrual accounting would ensure that the Administration and the Congress faced the full costs of their pay raise decisions as they made them.

An accrual system might also improve defense decisions involving cost tradeoffs among weapons systems requiring different numbers of active-duty personnel for operation and maintenance. The Navy is currently completing the design of a new destroyer, which will be bought in large numbers, and the Air Force is beginning the design of a new fighter aircraft. These and many other weapons can probably be manned with fewer personnel if special equipment is added, or alternatively can use larger crews and less labor-saving equipment. In estimating life-cycle costs of future weapons, there may be a tendency to understate personnel costs since retirement outlays would not show up in the budget for many years. Under accrual accounting, defense programmers and Congressional committees would have more incentive to recognize retirement costs fully in such weapons decisions.

Another advantage of an accrual system is that revisions in the military retirement plan would immediately be reflected in the size of the accrual charge. This would aid the Congress in evaluating the long-range budgetary effects of prospective modifications in the retirement system. 6/

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6. Accrual accounting as a federal budgeting practice has a long, but unsuccessful, legislative history. The first stirrings of legislative interest in accrual accounting can be traced to the Budget and Accounting Procedures Act of 1950, which required the approach as a prerequisite to approval of agency accounting systems by the Comptroller General. A 1956 amendment to that act (P.L. 84-863) made it mandatory for agency accounts, but the term lacked precise definition

Under current accounting procedures, full costs of changes in future retirement benefits would usually not appear in the current budget. An example can be taken from recent history. In 1980 the Congress decided to base military retirement pay on average pay during the three years when pay was highest, rather than pay at the date of retirement. This "high-three" provision was made applicable, however, only to those entering the military after enactment of the legislation, thus ensuring that nondisability retirement costs would not be affected for almost 20 years. Consequently, the budget showed little immediate change. Had accrual accounting been in effect in 1980, the accrual charge and hence the defense budget would immediately have shown a reduction of about \$1.2 billion. In the same way, accrual accounting would make clear the long-range benefit changes considered during any future Congressional debate over military retirement. This would avoid undue emphasis on immediate benefit cuts that offer short-term savings.

Potential Concerns and Ways to Minimize Them

Despite its many important advantages, implementation of accrual accounting raises some potential concerns. Nevertheless, with the proper measures the concerns would be avoided or minimized.

One issue would be what assumptions to use in calculating the accrual charge. The charge is an estimate of the amount that would have to be set aside in a current year to provide all retirement benefits attributable to the current year's service. It is very sensitive to economic and actuarial assumptions about the future course of interest rates, wages, and productivity; future mortality; and rates of disability, retirement, or withdrawal from the system. As an example, lowering the assumed annual real rate of interest from 1.0 percent to 0.5 percent would raise the accrual charge in 1985 by \$2.4 billion or 14 percent.

The sensitivity of the accrual charge to differences in technical assumptions inevitably raises questions of the system's integrity and susceptibility to short-run budgetary pressures. These concerns could be allayed by establishing an independent board of actuaries to set and adjust the accrual charges and related calculations after determining the appropriate

and has never been implemented. For a discussion of accrual accounting's broader implications for federal budgeting, see Congressional Budget Office, "Federal Financial Reporting: Accrual Accounting and the Budget," Technical Analysis Paper (June 1977).

economic and actuarial assumptions. The House Armed Services and Administration approaches both require the appointment of such a board.

During the transition from the current military retirement system to an accrual cost approach, the proposed accounting changes could appear to alter the size of the defense function even if there was no real change in activity. This might lead to confusion over the real rate of defense growth, particularly if a defense budget under the accrual system was compared with a previous one not under accrual accounting. Such difficulties could be avoided by restating the defense budgets for earlier years in terms of the new accounting procedures.

Accrual Accounting Widely Recommended

Because it offers many advantages, and no problems that cannot be avoided or minimized, accrual accounting has been widely recommended. Both this Administration and its predecessor have proposed the change. Accrual accounting has also been recommended by the General Accounting Office and by a commission set up in 1976 to study defense manpower problems. 7/

7. See Comptroller General of the United States, Need for Overall Policy and Coordinated Management of Federal Retirement Systems, vol. 1 (December 1978), and Defense Manpower Commission, Defense Manpower: The Keystone of National Security (April 1976).